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GOVERNOR'S BUDGET

SPRING REVISION SUPPLEMENT

1989-90

STATE OF CALIFORNIA

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Economic Outlook

THE NATION

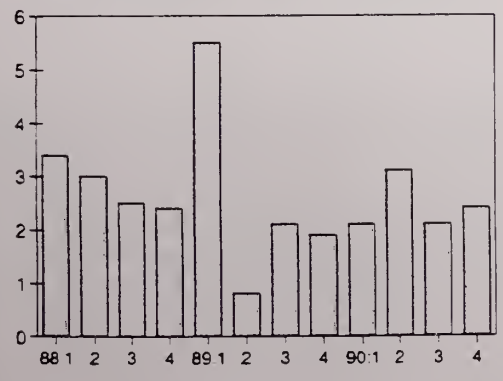
The national economic forecast has been revised up moderately from that shown in the Governor's Budget. This can be attributed primarily to the fact that the economy was stronger than anticipated for the last quarter of 1988 and the first months of 1989. Even moderate growth from this point will lead to larger gains for 1989 as a whole.

There has not been any change in the assumption that Federal Reserve policies will gradually slow business activity. Monetary policy aimed at raising interest rates, slowing the growth in the economy, and thereby curbing potential inflationary pressures appears to be taking hold. Housing starts have fallen significantly. Auto sales are below earlier forecasts. Durable goods orders have been soft so far this year. Employment growth has eased. Inflation indicators have come in below expectations.

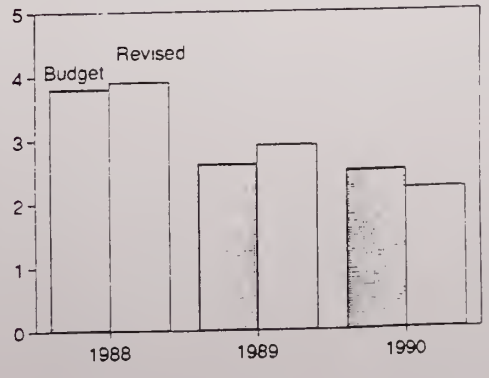
Developments of this sort are indicative of a "soft landing" -- an economy in which growth is gradually reduced to eliminate excessive demand, thus easing price pressures. A successful soft landing avoids recession, and permits the economy to adjust with little disruption in production and employment.

However, soft landings are difficult to see in the usual annual data presented since they are measured in terms

REAL GROSS NATIONAL PRODUCT
Quarterly percent change, annual rate



FORECAST COMPARISONS:
REAL GROSS NATIONAL PRODUCT
Annual percent change



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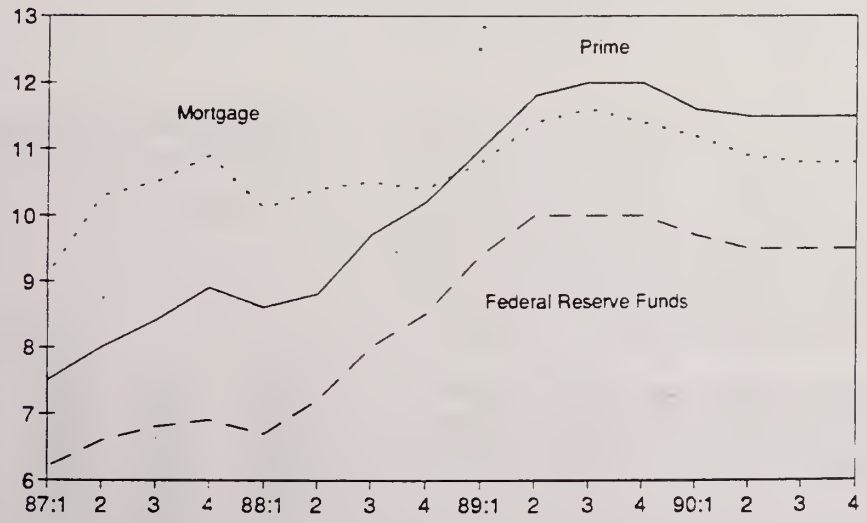
of quarter-to-quarter changes in critical measures such as real gross national product. Real GNP, for instance, is forecast up 2.9 percent. The first quarter expanded at 4.3 percent rate (initially reported at 5.5 percent with statistical adjustments for the 1988 drought adding 2.5 percent to the quarter's growth). The second quarter will undoubtedly be anemic in comparison. From that time on, however, growth in the 2 to 2-1/2 percent range is being sought by the Federal Reserve. The exception in the second quarter of 1990, seen in the accompanying graph, is due to activity for the 1990 census.

Federal Reserve Policy

Earlier tightening by the Federal Reserve, reflected in the 3 percent point rise in the federal funds rate since early 1988, has apparently been successful in curbing the pace of expansion. The slowdown which has already occurred and the recent strength of the dollar will discourage the Federal Reserve from taking further

COMPARATIVE INTEREST RATES

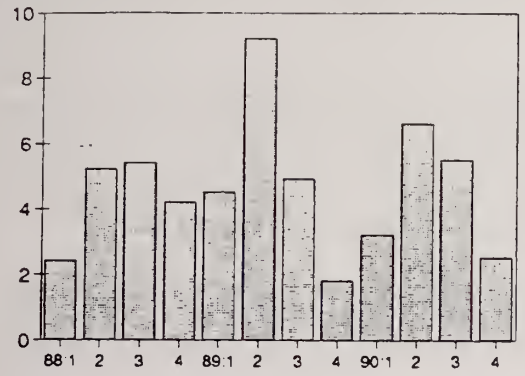


significant moves toward higher interest rates. The forecast assumes that interest rates are peaking in the current quarter with the prime at 11-1/2 or 12 percent and conventional mortgage rates between 11-1/2 percent and 11-3/4 percent. The rates remain relatively stable until early 1990, when the Federal Reserve eases to prevent the economy from sliding into a recession.

Inflation

Inflation indexes for 1989 will be distorted by a number of aspects, including aftereffects from the 1988 drought. A greater effect on consumer prices for the second quarter 1989 will come from the substantial run-up in gasoline prices following the Alaskan oil spill, loss of North Sea production and the upward drift in OPEC prices. All of these factors are temporary, however. Crude oil prices are easing and are expected to settle in the $17 to $19 per barrel range. Retail gasoline prices have shown some signs of moving off the highs posted in April, although any significant decline will undoubtedly be delayed until the end of the summer driving season. This normal seasonal drop, in conjunction with other typical price easing in the fourth quarter, accounts for the significant improvement in the rate of inflation at the end of the year.

CONSUMER PRICE INDEX
UNITED STATES
Quarterly percent change, annual rate

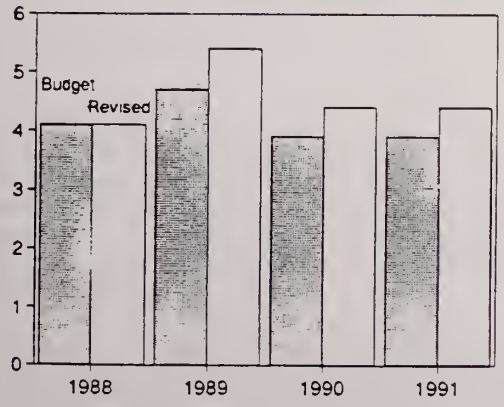


Industry Indicators

Higher interest rates have already had an impact on business. Car sales are soft and incentives are proving less effective than in the past in revitalizing demand. There is a strong possibility that the consumer is taking a breather after six years on a buying spree.

Industrial production appears to be on a plateau. This is due at least in part to the rise in the value of the U.S. dollar in recent months, which has slowed the growth of manufactured exports. Modest improvement in the nation's trade balance is expected over the next two years, however, the growth in imports is expected to slow. This will be attributable to both the slowdown in demand and increased domestic output from foreign investment in industrial plants in the United States.

FORECAST COMPARISONS:
U.S. CONSUMER PRICE INDEX
Annual percent change



Cutbacks in defense spending are also having an impact. Recent announcements of large aircraft orders will provide an offset over the next few years, but are not likely to strengthen output in the 1989-90 fiscal year.

Construction activity remains strong; however, plans for new projects, reflected in building permits, are down from earlier peaks. Vacancy rates remain high for commercial space in most metropolitan areas and construction on the pipeline could exacerbate the problem in coming months. Housing starts have been soft since the tax act of 1986 went into effect, and nationally show few signs of coming to life. Rising mortgage rates and well-publicized adjustments on Adjustable Rate Mortgages (ARMs) will also discourage demand.

Employment and Income

Job gains have softened since the start of the year. This is a somewhat difficult indicator to interpret at the present time. To some extent, it reflects a slowdown in activity. It is also possible that seasonal factors did not adequately adjust for unusual weather in the first quarter. On average, however, the quarter was in line with an outlook for moderate growth during the year. The forecast calls for job growth of 3.3 percent in 1989 and 2.7 percent in 1990. The acceleration in the second quarter of 1990 is attributable to temporary federal census workers. The unemployment rate averages approximately 5 percent through the end of 1990.

Personal income is expected to rise by 9.3 percent this year. Farm proprietors income, with statistical adjustments for 1988 drought impacts and interest income, are responsible for much of the improvement from the Budget forecast. Rising interest rates will lead to a 17 percent gain in interest income this year.

The largest component of income--wages and salaries--will be up 8.6 percent nationally, reflecting employment growth of 3.3 percent and average wage gains of 4.5 percent to 5 percent overall.

CALIFORNIA

Recent Developments

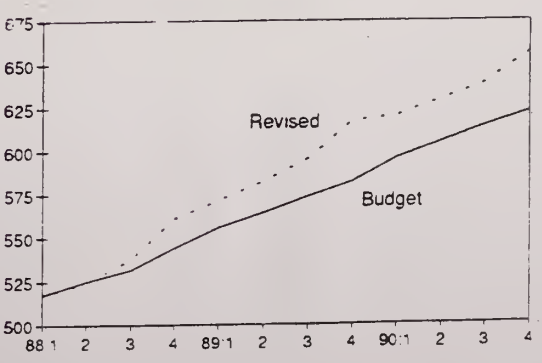
In California, the pickup in economic activity during the second half of 1988 was considerably more pronounced than was the case nationally. Following a brief pause in growth during the second quarter of 1988, gains in both employment and income accelerated dramatically during the third and fourth quarters of the year, and this strength has carried over into the opening months of 1989.

Although the forecast continues to call for a moderating pace of economic growth over the next 18 months, the point of departure is now much higher than was contemplated late last year when the Budget outlook was prepared. As a result, gains in most measures of activity--especially for 1989--are considerably more than previously forecast.

Specifically, personal income in now projected to grow 10.6 percent in 1989, three full percentage points more than the Budget forecast of 7.5 percent. In dollar terms, the increase from the previous forecast is just short of $20 billion. The expected 1990 gain of 7.6 percent is more in line with the Budget forecast of 7.1 percent, although the absolute level of income is some $27 billion higher.

FORECAST COMPARISONS:
CALIFORNIA PERSONAL INCOME

(Dollars in billions)



Likewise, 1989 employment growth has been increased from 3.2 percent to 5 percent. Average employment for the year is a quarter of a million jobs more than in the Budget.

The primary source of employment and income data for California is the payroll tax system. At the time the Budget forecast was prepared, the most recent available payroll report was for the weak second quarter of 1988. Subsequent reports for the third and fourth quarters of last year resulted in substantial upward revisions in the estimates of both employment and income. These later reports suggest that as of March, employment was up 5-1/2 percent on a year-over-year comparison.

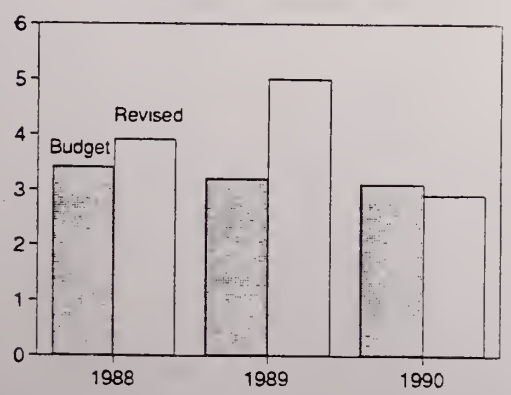
Employment and the Labor Market

The forecast of 5 percent employment growth for all of 1989, therefore, implies a slowdown over the remainder of the year. While the more recent payroll figures consistently boosted the Department's estimates of employment, the gains have been somewhat uneven, concentrated in services, construction and wholesale and retail trade. Manufacturing, while moving up slightly, has not been a source of exceptional strength. In particular, the more recent data suggest a weaker trend in high technology manufacturing, especially aerospace.

Accounting for more than one-third of all manufacturing jobs, aerospace and electronics are extremely important basic industries in California. Reduced defense budget growth implies further weakness in the aerospace group, even though booming commercial airline orders are providing an offset in the aircraft industry. The effects of the defense slowdown are most visible in the aerospace instruments industry, where employment

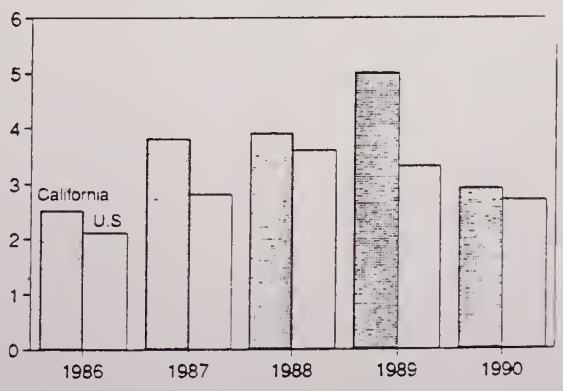
FORECAST COMPARISONS: CALIFORNIA NONAGRICULTURAL EMPLOYMENT

Annual percent change



NONAGRICULTURAL EMPLOYMENT CALIFORNIA AND UNITED STATES

Annual percent change



dropped almost 10 percent between the first quarters of 1988 and 1989. At the same time, the commercial electronics industry is expecting lackluster growth, in line with the forecast of somewhat smaller gains in business equipment spending. It is doubtful that the recent rapid growth in services, trade and construction will be sustained given the slowing in the high technology group.

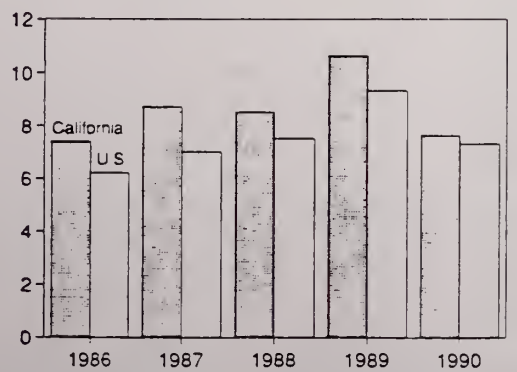
Construction will be affected by the rise in interest rates experienced over the past year. However, California's housing market remains considerably stronger than in the rest of the nation, and interest rates are expected to have only a modest dampening effect on the homebuilding industry. Nonresidential construction, however, is expected to be affected by both interest rates and the ample supply of commercial office space in most major markets.

California's low jobless rate may be another factor limiting employment growth in the year ahead. While the monthly jobless rate is quite volatile, the rate is now averaging less than 5 percent and is likely to settle at about 4-1/2 percent this year and next. A 4-1/2 percent statewide jobless rate implies very tight labor market conditions in the Bay Area and Southern California, where jobless rates of 3 percent or less are increasingly common.

Personal Income

In addition to strong employment growth, personal income has been boosted by the rise in interest rates and special factors in the professional services industries. Interest income, which as recently as the second quarter of 1988 was growing at an annual rate of about

PERSONAL INCOME
CALIFORNIA AND UNITED STATES
Annual percent change



$1.2 billion, jumped by almost $4 billion in the opening months of 1989. Growth of this magnitude is expected to continue through at least the end of summer, before a gradual decline in interest rates slows the gains in interest income.

Federal and state personal and corporate income tax revisions have had a significant effect on professionals such as doctors, lawyers, dentists, and accountants, and their professional service corporations (PSCs). With corporate tax rates now generally higher than personal rates, most profits are now "stripped" from PSCs at the end of each year, and paid to the principals in the form of wages. In the final quarter of 1988, it appears that over $2 billion (nearly $9 billion at an annual rate) of PSC profits were shifted into wage and salary income. Had these profits been retained in the corporations, they would not have been counted as part of personal income. PSCs accounted for nearly 40 percent of the unprecedented $23 billion fourth quarter income surge. It is expected that similar large payments, which are included in the forecast will boost income in the final quarters of 1989 and 1990. Although this year's 10.6 percent rise in personal income may appear exceptionally strong, the gain essentially reflects a surge in income which has already occurred. Moreover, the gap between California's growth and the nation's 9.3 percent advance is not unusually large, especially considering that the national figures do not as yet fully reflect the PSC effects. National figures for 1989 do include drought recovery effects, which are not a factor in the California income data.

Consumer Prices

The outlook for inflation in California is not substantially different from the Budget forecast. The California Consumer Price Index is expected to increase 5.8 percent in 1989 and 4.8 percent in 1990. The gap between the California and U.S. inflation rates seems to be narrowing, despite the January tobacco tax increase, which adds nearly 1/2 percentage point to California's 1989 inflation rate.

In addition, transportation costs-- especially in the Los Angeles area --are expected to increase more than the national average, reflecting the recent run-up in gasoline prices. Housing costs are also rising a little faster than the national average, although not to the extent suggested by the 20 to 30 percent gains in existing home prices reported by the state's realtors.

These pressures are being offset by trends in several other categories of expenditure, including medical care, entertainment and clothing, which are showing less rapid price increases in California than nationally.

UNITED STATES
SELECTED ECONOMIC DATA

COMPARISON OF THE BUDGET FORECAST AND THE SPRING REVISION

(Dollars in billions)

	Governor's Budget			Revised		
	1988	1989	1990	1988	1989	1990
Real GNP (S82)	S3,993.2	S4,098.6	S4,199.8	S3,996.0	S4,110.0	S4,200.4
% change	3.8	2.6	2.5	3.9	2.9	2.2
Personal income	S4,055.0	S4,349.4	S4,640.0	S4,062.1	S4,439.4	S4,762.0
% change	7.3	7.3	6.7	7.5	9.3	7.3
Corporate profits	295.1	296.2	275.4	306.6	303.9	301.7
% change	6.7	0.4	-7.0	10.8	-0.9	-0.7
Nonagricultural wage & salary employment (mn)	106.0	109.0	111.9	106.0	109.5	112.5
% change	3.6	2.8	2.7	3.6	3.3	2.7
Unemployment rate (%)	5.5	5.3	5.2	5.5	5.1	5.0
Housing starts (mn)	1.47	1.39	1.49	1.49	1.45	1.47
% change	-10.3	-5.0	7.2	-8.5	-2.7	1.0
New car sales (mn)	10.6	10.2	10.1	10.6	10.1	10.1
% change	3.1	-3.7	-1.2	3.5	-5.3	-0.1
Consumer price index (1982-84=100)	118.2	123.8	128.7	118.3	124.6	130.1
% change	4.1	4.7	3.9	4.1	5.4	4.4
GNP deflator (1982=100)	121.6	126.1	130.0	121.7	127.2	132.6
% change	3.3	3.7	3.1	3.4	4.5	4.2

Note: Percent changes calculated from unrounded data.

May 1989

CALIFORNIA
SELECTED ECONOMIC DATA

COMPARISON OF THE BUDGET FORECAST AND THE SPRING REVISION

(Dollars in billions)

	Governor's Budget			Revised		
	1988	1989	1990	1988	1989	1990
Personal income	$529.4	$568.9	$609.1	$534.8	$591.8	$636.5
% change	7.4	7.5	7.1	8.5	10.6	7.6
Wages & salaries	$316.1	$338.6	$363.1	$321.1	$353.9	$380.8
% change	7.2	7.1	7.3	9.0	10.2	7.6
Corporate profits	48.0	52.0	55.8	49.1	54.1	58.3
% change	8.4	8.3	7.3	7.4	10.2	7.8
Nonagricultural wage & salary employment (th)	12,109	12,492	12,881	12,138	12,747	13,115
% change	3.4	3.2	3.1	3.9	5.0	2.9
Unemployment rate (%)	5.4	5.1	5.2	5.3	4.6	4.4
Housing starts (th)	237	212	249	253	232	249
% change	-4.5	-10.7	17.4	1.7	-8.3	7.6
New car sales (th)	1,467	1,424	1,460	1,467	1,424	1,460
% change	2.4	-2.9	2.5	2.4	-2.9	2.5
Consumer price index (1982-84=100)	121.8	128.6	134.5	121.9	129.0	135.2
% change	4.6	5.6	4.6	4.6	5.8	4.8

Note: Percent changes calculated from unrounded data.

May 1989

Revenue

General Fund revenues and transfers are now expected to be $37.0 billion in the current year and $40.3 billion in the budget year. This represents an increase from the January Budget forecast of $1,041 million in the current year and $1,379 million in the budget year. The income tax is almost entirely responsible for this increase. The following table summarizes the forecasts and change.

GENERAL FUND REVENUES AND TRANSFERS
(Dollars in millions)

	1988-89	1989-90
Budget Forecast:	$36,001	$38,876
Spring Revision Forecast:	37,042	40,255
Personal Income Tax	+1,245	+1,230
Sales Tax	0	+82
Bank and Corporation Tax	-45	+150
All Other	-159	-83
Net Change:	+$1,041	+$1,379

Background

In April of this year it became evident that the combination of a stronger 1988 economy and higher capital gain realizations resulted in significantly more revenues than had been forecast. This increase is believed to be ongoing, resulting in the expectation of higher budget year revenues.

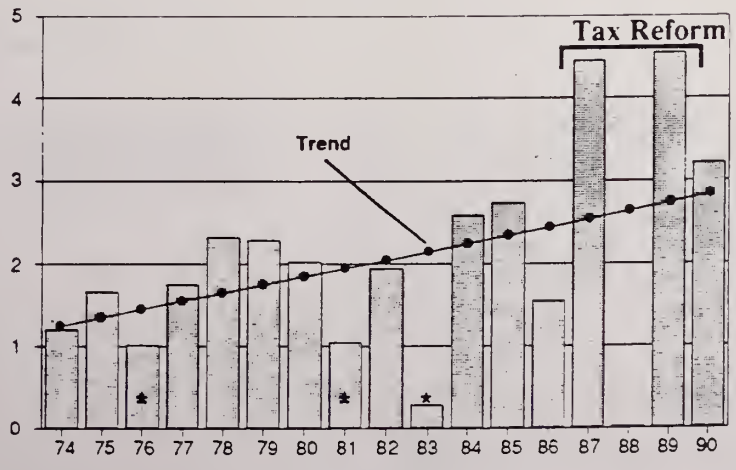
The following chart shows the year-to-year change in General Fund revenues. The most recent three fiscal years have been unusually difficult to forecast with a high degree of accuracy due in major part to the

volatility in the personal income tax. The 1987, 1988, and 1989 fiscal years were affected by both the Federal Tax Reform Act of 1986 and subsequent state conformity to federal law. The forecast assumes that the more dramatic changes are now behind us and that the budget year will be consistent with the economic forecast and the long-term trend of revenues.

The difficulty with recent forecasts is due in part with taxpayers having changed their behavior as a result of federal tax reform in 1986 and the state's conformity in 1987. Capital gains are now fully taxed. This revenue component is subject to taxpayer discretion (i.e., to sell or not to sell an asset) and, hence, is very sensitive to changes in tax law, market conditions and individual circumstances. Capital gains have always been a volatile item and since they contribute to a greater percentage of our total revenue, it makes these collections subject to greater variance.

In addition, a greater percentage of taxable income is attributable to a few very high income persons. Forecasting relies, in part, on the stability inherent in the actions of large numbers of people. When only a few people are involved, the stability factor is significantly less. For example, in 1985 (the last actual published data), 68 percent of the net capital gains ($10 billion) were reported by only 117,000 taxpayers and less than 2 percent of the taxpayers accounted for over 15 percent of all adjusted gross income. Until the behavior of high income taxpayers is better understood, a higher degree of uncertainty will remain with the forecasting process.

YEAR-TO-YEAR CHANGE
GENERAL FUND REVENUES
(Dollars in billions)



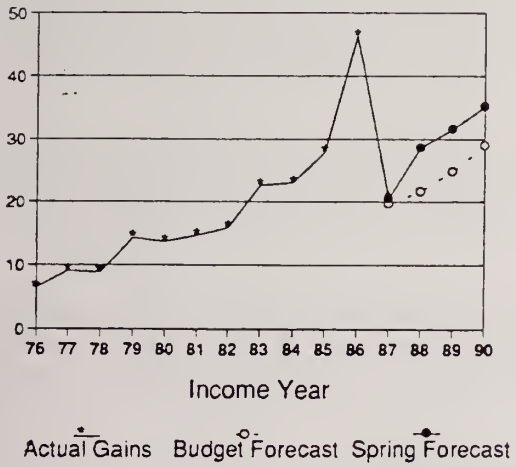
* Recession
79 & 80 adjusted for tax credit

Personal Income Tax

1988-89	$15,960 million
1989-90	$17,580 million

CAPITAL GAINS PROFITS

(Dollars in billions)



Personal income tax revenues attributable to the 1988 tax year were substantially stronger than expected. At this time, there is no definitive evidence as to why this occurred, however, it is apparent that the economy outperformed expectations. The forecast assumes that the stronger economy added $333 million to the current year and $600 million to budget year revenues. However, although personal income growth was 8.5 percent in 1988, personal income tax liability growth exceeded 20 percent because other factors such as legislative action and taxpayer behavior also played a role.

Capital gains, always a source of much volatility, are also believed to be stronger than had been anticipated in the budget. Higher effective tax rates due to federal and state tax reform were believed to have caused some taxpayers to "lock-in" their investments rather than sell and pay the higher rate. However, it now appears that this "lock-in" effect may have been much less than expected. This, combined with a strong market, was estimated to increase gains during 1988 by 40 percent. This increase would put profits from the sales of capital assets close to historical trend levels after federal tax reform led to a dramatic rise in 1986 with a precipitous decline the following year. (See capital gains profits graph.)

Given the drop in federal tax rates between 1987 and 1988, it also appears that taxpayers may have accelerated deductions into 1987 and income into 1988, thus causing unusually low receipts last year and additional strength in 1988-89 revenues. This factor is believed to account for a one-time gain of $200 million in the current year.

Sales and Use Tax

1988-89	$12,520 million
1989-90	$13,450 million

Sales and use tax revenues are forecast to be unchanged from the Budget forecast for the current year, and has increased by $82 million for the budget year reflecting a continued trend of the relatively stable growth that has occurred since the 1982-83 recession. Before adjusting for the following three factors, the current forecast for 1989-90 revenues has increased by $161 million from the Budget estimate:

- The Budget estimate for 1989-90 revenues included a transfer of $80 million from the Retail Sales Tax Fund to the Transportation Planning and

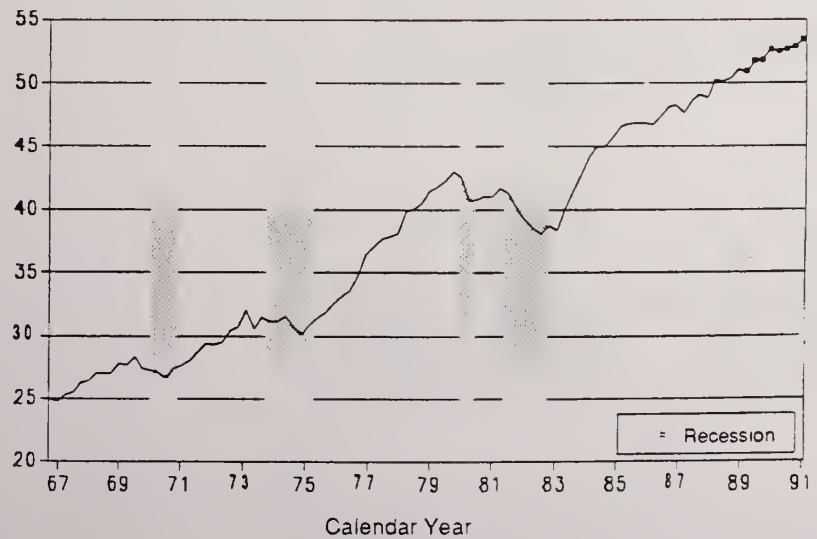
Development Account. This represents the amount of revenue that was estimated to be received from the state sales tax on diesel fuel sales. The estimate has been increased to $90 million as a result of the recent increase in fuel prices, thereby reducing General Fund revenues by $10 million for the budget year.

- Assuming that action would be taken at the federal level, the Budget estimate included $108 million in 1989-90 revenues which were estimated to be received from use tax collections on mail order sales pursuant to Chapter 1144, Statutes of 1987, (Bellas Hess). However, it appears unlikely that federal legislation will be enacted in the coming year and the 1989-90 General Fund estimate for these collections has been reduced to $40 million. This reduces the budget year revenue forecast by $68 million.

- The Budget estimate for 1989-90 revenues included $30 million in sales tax revenues that were expected to be received from Proposition 99, the cigarette tax increase. This estimate has been reduced by $1 million.

The stability of the sales tax trend, which should continue unless a recession occurs, is shown in the following graph of taxable sales in constant 1982 dollars.

TAXABLE SALES
Constant 1982 Dollars
(Dollars in billions)



Forecast begins first quarter 1989

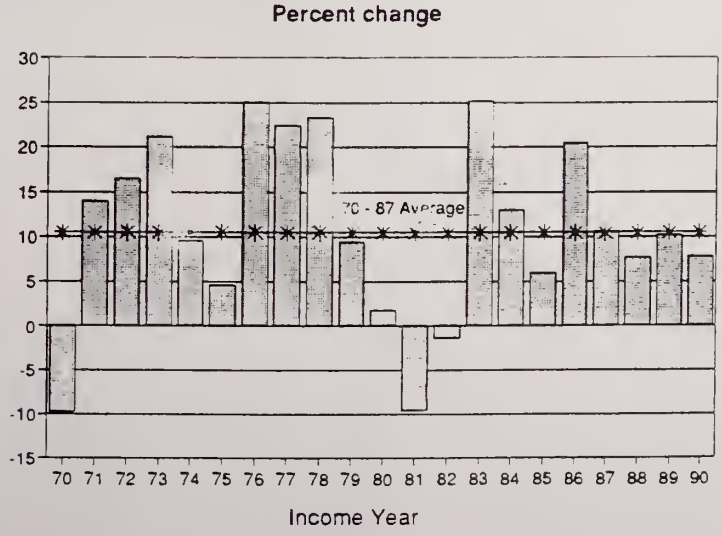
1988-89	**$5,170 million**
1989-90	**$5,700 million**

The bank and corporation tax revenues are forecast to be down from the Budget forecast by $45 million in the current year. For the budget year, revenues are forecast to be up $150 million.

The revised economic forecast added about $25 million to the current year and $150 million to the budget year, accounting for all of the revenue increase. The current year shortfall is assumed to be the residual effect of recent federal tax reform and state conformity to federal legislation. This forecast assumes that such residual effects have now become insignificant.

The forecast is more positive than the national corporate profits trend would indicate. The year-to-year change in national corporate profits is forecast to be -0.9 percent and -0.7 percent for 1989 and 1990 respectively, whereas the year-to-year changes in California taxable profits are forecast to be +10.2 percent and +7.8 percent. The growth in California taxable profits has never been negative except in times of economic recession and even then in some instances has remained positive. The average annual percentage change for California taxable profits over the last two decades is about 10 percent per year. Thus, this forecast is about average, as shown in the following graph, on the year-to-year change in California taxable profits and thus is more consistent with the overall California economic forecast.

YEAR-TO-YEAR PERCENT CHANGE IN CALIFORNIA TAXABLE PROFITS



Actual through mid-87

Other Revenues and Transfers

1988-89	$3,392 million
1989-90	$3,525 million

Other revenues and transfers are estimated to be down $159 million in the current year and $83 million in the budget year. The major differences from the budget forecast are occurring in the following four items:

- The estate tax collections are $28 million below our forecast in the current year and $38 million below for the budget year. We believe the recent tax changes have increased estate planning resulting in lower receipts.

- The insurance tax is estimated to be down $80 million in the current year and $4 million in the budget year, reflecting the recent court ruling on the method of taxing "minimum premium plans" and other market place disruptions.

- Interest income has been revised downward by $20 million in 1988-89 and $28 million in 1989-90. The current year revision is due to reduced Pool balances available for investment. The reduction in the budget year estimate is due to a decrease in the external borrowing that will be undertaken. Given the current fiscal conditions, $2.5 billion in Revenue Anticipation Notes are expected to be sold in 1989-90, rather than the $3.5 billion anticipated in the Budget.

- For abandoned property, collections are down $40 million in the current year. Almost all of this shortfall is the result of the state not receiving the proceeds from a settlement with one large bank.

SPRING REVISION
GENERAL FUND REVENUE FORECAST
(Dollars in millions)

Source	Fiscal Year	Budget Forecast	Revised Forecast	Difference
	1988-89			
Personal Income Tax		$14,715	$15,960	+$1,245
Sales Tax		12,520	12,520	0
Bank & Corporation Tax		5,215	5,170	-45
Other Revenues & Transfers		3,551	3,392	-159
Total		$36,001	$37,042	+$1,041
	1989-90			
Personal Income Tax		$16,350	$17,580	+$1,230
Sales Tax		13,368	13,450	+82
Bank & Corporation Tax		5,550	5,700	+150
Other Revenues & Transfers		3,608	3,525	-83
Total		$38,876	$40,255	+$1,379
Change from 1988-89:		+$2,875	+$3,213	
Percent Change from 1988-89:		8.0%	8.7%	
Total Difference:				+$2,420
Total Percent Difference:				+3.2%